

SEC's Division of Corporation Finance Revises CD&Is on Non-GAAP Financial Measures

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On December 13, the U.S. Securities and Exchange Commission's (SEC) Division of Corporation Finance staff (the staff) updated its Compliance & Disclosure Interpretations (CD&Is), concerning the [use of non-generally accepted accounting principles \(GAAP\) financial measures](#) in public company disclosures. The updates include both revisions to existing CD&Is and new guidance reflecting the staff's position on the use of non-GAAP financial measures in public company disclosures. The revised CD&Is largely confirm and reinforce the staff's position on the use of these measures, providing additional clarifications and examples of disclosures the staff would find objectionable.

The updated CD&Is are as follows:[\[1\]](#)

Question 100.01.

Revised Question 100.01 adds context to the staff's position with respect to adjustments made to create a non-GAAP measure, which, although not explicitly prohibited, could result in the staff considering a non-GAAP measure as misleading. The amended language reinforces the staff's belief that non-GAAP measures that exclude normal, recurring, cash operating expenses necessary to operate a business could be misleading. When evaluating what constitutes a normal, operating expense, the revised CD&I provides that the staff will consider the nature and effect of the non-GAAP adjustment and how it relates to the company's operations, revenue generating activities, business strategy, industry, and regulatory environment. Revised Question 100.01 clarifies the staff's position that such an operating expense could be considered recurring even where the expense occurs only occasionally, including at irregular intervals.

Question 100.04

Revised Question 100.04 reinforces the staff's position that non-GAAP measures could violate Rule 100(b) of Regulation G if the measurement principles used to calculate the measure are inconsistent with GAAP. Previously, Question 100.04 affirmed that "non-GAAP measures that substitute individually tailored revenue recognition and measurement methods for those of GAAP could violate Rule 100(b) of Regulation G," citing as an example a non-GAAP performance measure that is adjusted to accelerate revenue recognized ratably over time in accordance with GAAP, as though revenue was earned when customers were billed. Revised Question 100.04 lists this as one of three non-exclusive examples of measures where the staff would view non-GAAP adjustments that have the effect of changing the recognition and measurement principles required to be applied in accordance with GAAP as individually tailored, with the effect of potentially causing the presentation of the non-GAAP measure to be

misleading. The two other examples are:

1. presenting a non-GAAP measure of revenue that deducts transaction costs as if the company acted as an agent in the transaction, when gross presentation as a principal is required by GAAP — or the inverse — presenting a measure of revenue on a gross basis when net presentation is required by GAAP; and
2. changing the basis of accounting for revenue or expenses in a non-GAAP performance measure from an accrual basis in accordance with GAAP to a cash basis.

Question 100.05

New Question 100.05 asks if a non-GAAP measure can be “misleading if it, and/or any adjustment made to the GAAP measure, is not appropriately labeled and clearly described.” The affirmative answer recognizes that non-GAAP measures will often be inconsistent or incomparable, and states that without an appropriate label and clear description, the non-GAAP measure and/or any adjustment made to arrive at the measure, could be misleading. The new CD&I provides the following examples of inappropriate labeling and descriptions that would cause a measure to violate Rule 100(b) of Regulation G:

1. Failure to identify and describe a measure as non-GAAP; and
2. Presenting a non-GAAP measure with a label that does not reflect the nature of the non-GAAP measure, such as:
 - a. a contribution margin that is calculated as GAAP revenue less certain expenses, labeled “net revenue”;
 - b. non-GAAP measure labeled the same as a GAAP line item or subtotal even though it is calculated differently than the similarly labeled GAAP measure, such as “gross profit” or “sales”; and
 - c. a non-GAAP measure labeled “pro forma” that is not calculated in a manner consistent with the pro forma requirements in Article 11 of Regulation S-X.

Question 100.06

Question 100.06 is a newly added question that asks whether a non-GAAP measure can be misleading and violate Rule 100(b) of Regulation G, even if accompanied by disclosure about the nature and effect of each adjustment made to the most directly comparable GAAP measure. Unsurprisingly, the staff answers in the affirmative, and states its position that a non-GAAP financial measure could mislead investors to such a degree that even extensive, detailed disclosure about the nature and effect of each adjustment would not prevent the non-GAAP measure from being materially misleading.

Question 102.10(a), (b) and (c)

Question 102.10, concerning the prominence of the presentation of non-GAAP financial measures was significantly revised, breaking the former CD&I into three separate questions. Item 10 of Regulation S-K requires that when a non-GAAP financial measure is used, it must also be presented with the most directly comparable GAAP measure in a way that gives the GAAP measure equal or greater prominence.

Question 102.10(a) retains the same question as prior Question 102.10, which asked for examples of disclosure that would cause a non-GAAP measure to be more prominent, but slightly revises the prior examples and adds additional examples.

First, the staff's answer stresses that the prominence requirements of Regulation S-K apply both to the presentation of, and any related discussion and analysis of, a non-GAAP measure (the need to include a similar discussion of non-GAAP and GAAP measures in any discussion and analysis was listed as an example under former Question 102.10). While acknowledging that the facts and circumstances in which disclosure is made are key to the ultimate analysis, the listed examples of disclosure that would cause a non-GAAP measure to be more prominent include:

1. Presenting an income statement of non-GAAP measures. This example revises the prior example warning against the use of a full-income statement of non-GAAP measures by reference to new CD&I Question 102.10(c), which explains what the staff considers a non-GAAP income statement (see [Question 102.10\(c\)](#), below).
2. Presenting a non-GAAP measure before the most directly comparable GAAP measure, or omitting the comparable GAAP measure altogether, including in an earnings release headline or caption that includes a non-GAAP measure. This revised example combines two examples from former Question 10.
3. Presenting a ratio where a non-GAAP financial measure is the numerator and/or denominator without also presenting the ratio calculated using the most directly comparable GAAP measure(s) with equal or greater prominence. This new example clarifies that a financial ratio using a non-GAAP measure could raise prominence concerns if the financial ratio is not presented using the most directly comparable GAAP measure.
4. Presenting a non-GAAP measure using a style of presentation (e.g., bold, larger font, etc.) that emphasizes the non-GAAP measure over the comparable GAAP measure. This example is unchanged.
5. Describing a non-GAAP measure as, for example, "record performance" or "exceptional" without at least an equally prominent descriptive characterization of the comparable GAAP measure. This example is unchanged.
6. Presenting charts, tables, or graphs of non-GAAP financial measures without presenting charts, tables, or graphs of the comparable GAAP measures, with equal or greater prominence, or omitting the comparable GAAP measures altogether. This example expands upon a former example, which just discussed tabular disclosures, by making clear that prominence issues can also arise with the use of charts and graphs.
7. Providing discussion and analysis of a non-GAAP measure without a similar discussion and analysis of the comparable GAAP measure in a location with equal or greater prominence. This example is unchanged.

Question 102.10(b)

New Question 102.10(b) expands upon the concepts embedded in the example to former Question 102.10, by asking if there are examples of disclosures that would cause the non-GAAP reconciliation required by Item 10 of Regulation S-K to give undue prominence to a non-GAAP measure. In this regard, the staff cautions against starting the reconciliation with a non-GAAP measure and presenting a non-GAAP income statement when reconciling non-GAAP measures to the most directly comparable GAAP measures.

In addition, new Question 102.10(b) contains the staff's position that, "when presenting a forward-looking non-GAAP measure, a registrant may exclude the quantitative reconciliation if it is relying on the exception provided by Item 10(e)(1)(i)(B) of Regulation S-K." New Question 102.10(b) goes on to state that "a measure would be considered more prominent than the comparable GAAP measure if it is presented without disclosing reliance upon the exception, identifying the information that is unavailable, and its probable significance in a location of equal or greater prominence."

Question 102.10(c)

The last of the revised CD&Is, new Question 102.10(c) asks, what is considered to be a non-GAAP income statement which the staff considers giving undue prominence to non-GAAP measures? In response, the staff states that it will consider a non-GAAP income statement as one that is comprised of non-GAAP measures and includes all or most of the line items and subtotals found in a GAAP income statement.

Conclusion

While these new CD&Is do not break new ground in the staff's position on the use of non-GAAP financial measures, the additional examples and clarifications will be helpful to public companies in drafting disclosures that avoid issues under Regulation G or Regulation S-K. As the staff continues to focus on non-GAAP financial measures in reviews of securities filings, the additional guidance should help companies avoid any staff comments on the use of non-GAAP financial measures. Additionally, the updated CD&Is may result in plaintiffs' attorneys examining SEC filings and press releases to look for disclosures that diverge from the guidance, and thereafter making demands on public companies to change their disclosures.

[1] A redline showing the relevant changes to the CD&Is is available [here](#).

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